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In the Supreme Court of the United States

OCTOBER TERM, 1987

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

DONALD E. CLARK AND PEGGY S. CLARK

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

DONALD B. AYER
Acting Solicitor General

WILLIAM S. ROSE, JR.
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

ERNEST J. BROWN
Attorney

Department of Justice
Washington, D.C. 20530
(202) 633-2217

75 pp

QUESTION PRESENTED

In this case, a relatively small corporation was merged into a subsidiary of a large publicly-owned corporation, and the sole shareholder of the acquired corporation received in exchange for his shares both cash and shares of the stock of the publicly-owned corporation. The question presented is whether that payment of cash had the "effect of the distribution of a dividend" within the meaning of Section 356(a)(2) of the Internal Revenue Code.

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No.

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DONALD E. CLARK AND PEGGY S. CLARK

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fourth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra,* 1a-14a) is reported at 828 F.2d 221. The opinion of the Tax Court (App., *infra,* 15a-39a) is reported at 86 T.C. 138.

JURISDICTION

The judgment of the court of appeals (App., *infra,* 40a) was entered on September 4, 1987. On November 24, 1987, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including January 2, 1988. On December 17, 1987, the Chief Justice further extended the time for filing a petition for a writ of certiorari to and including January 11, 1988. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTE INVOLVED

The relevant portions of Sections 302, 316, 317, 354, and 356 of the Internal Revenue Code (26 U.S.C.) are set forth in a statutory appendix (App., *infra,* 41a-45a).

STATEMENT

For some time prior to April 1979, respondent Donald E. Clark[1] was the president of Basin Surveys, Inc., a West Virginia corporation that furnished radiation, nuclear, and electronic open-hole logging services to the petroleum industry, and he owned all of its outstanding 58 shares of stock. N.L. Industries, Inc. (NL) was then a publicly-held New Jersey corporation engaged in manufacturing and supplying petroleum equipment and services, chemicals, and metals. NL had outstanding approximately 32,533,000 shares of a single class of common stock and 500,000 shares of preferred stock. That stock was publicly traded on the New York and Pacific Stock Exchanges. N.L. Acquisition Corp. (NLAC) was a wholly owned subsidiary of NL. App., *infra,* 16a.

In 1978, NL had initiated discussions with respondent concerning the possible acquisition of Basin. After several months of negotiations, NL offered respondent alternative terms for the acquisition of Basin: (1) 425,000 shares of NL common stock without cash; or (2) 300,000 shares of common stock and $3,250,000 in cash. Respondent decided in favor of the latter alternative. App., *infra,* 16a.[2]

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[1] Respondent Peggy S. Clark is a party herein only because she filed a joint federal income tax return for the calendar year 1979 with her husband, respondent Donald E. Clark. References to "respondent" in the singular will be to Donald E. Clark.

[2] In the Tax Court, respondent's attorney testified (and it was agreed that, if called, respondent would testify to the same effect) that, after receiving NL's alternative offers, respondent had requested

On April 3, 1979, an agreement and plan of merger was executed by Basin, NLAC, NL, and respondent. The plan provided that, on April 18, 1979, Basin would merge with and into NLAC, which would change its name to Basin Surveys, Inc., and that respondent would receive, with respect to each of the 58 shares of Basin that he owned, 5,172.4137 shares of NL common stock and $56,034.482 in cash. The merger took place as planned. Respondent received 300,000 shares of NL common stock and $3,250,000 in cash, and ne entered into an employment agreement with Basin Surveys, Inc., for three years and an agreement not to compete for five years. The parties stipulated that the merger of Basin into NLAC was effected pursuant to, and qualified as a reorganization under, Section 368(a)(1)(A) and (a)(2)(D) of the Internal Revenue Code.[3] App., *infra,* 16a-17a.

2. Section 356(a)(1) of the Code provides that, if cash or other property is received in the course of what would otherwise be a tax-free, stock-for-stock reorganization, the recipient must recognize his gain on the transaction up to the value of that other property received. Accordingly, in their joint federal income tax return for 1979, respondents reported the cash received in the merger, com-

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the NL representatives to leave the room, so that the two of them could discuss the matter. In that discussion, the factors that led to a tentative choice of the latter alternative were that respondent's "whole livelihood was tied up in his company," and that an all-stock deal would involve the risk of serious loss if something happened to NL. Moreover, the stock of NL that was to be received would not be registered stock, but would be restricted letter stock, which would mean, under SEC rules, that respondent would have to hold the stock for a couple of years if he wanted to sell it and receive full value. And, in view of respondent's complete involvement with his company, that, in turn, would have meant that he could not pay his outstanding bills. C.A. App. 48-53.

[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code (26 U.S.C.), as amended (the Code or I.R.C.).

monly known as "boot," as taxable gain.[4] They characterized this amount as long-term capital gain. Section 356(a)(2) of the Code, however, requires that, if the exchange "has the effect of a distribution of a dividend," the recipient must treat the property received as a dividend to the extent of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. Under this Section, the Commissioner determined that $2,319,611 of the reported gain (i.e., the amount of the accumulated earnings and profits of Basin at the time of the merger) should be treated as a dividend and therefore taxable as ordinary income rather than as capital gain. This determination resulted in an asserted deficiency of $972,504.74 in federal income taxes for 1979.

3. Respondents petitioned for review in the Tax Court, which ruled in their favor in a reviewed decision (App., *infra,* 15a-39a). The court viewed the question whether respondents' receipt of cash in the merger had the effect of the distribution of a dividend as turning on a choice between two "judicially articulated tests" set forth in *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973), and *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979) (App., *infra,* 18a). According to the Tax Court, the *Shimberg* test would treat the cash distribution as if it constituted a distribution by the acquired corporation prior to the merger, and the *Wright* test would treat the cash payment as if it constituted "a distribution by the *acquiring* corporation (NL) in a hypothetical redemption of the shares of NL stock that would have been received if petitioner had accepted stock in lieu of the cash consideration" (App., *infra,* 18a (emphasis in original)).

[4] The figure reported by respondents on their return was $3,195,294. In their later computation for entry of decision by the Tax Court, respondents acknowledged that the amount of gain recognized and reported should have been $3,250,000.

The Tax Court then concluded that it should follow *Wright* and treat the cash payment as part of a post-merger hypothetical redemption of the 125,000 shares of NL stock that respondent declined to accept as payment. The court stated that this approach was necessary if the cash payment is to "be viewed and tested within the context of the entire reorganization" (App., *infra,* 33a). Because such a hypothetical redemption would have reduced respondent's holdings in NL from 425,000 to 300,000, it would not have been essentially equivalent to a dividend under the redemption provisions of the Code (see Section 302(b)(2)).[5] Under the Tax Court's approach, this conclusion meant that the cash received by respondents should not be viewed as a dividend in the reorganization context either, and therefore respondents were entitled to capital gain treatment upon the reported gain. App., *infra,* 34a-35a.

4. The court of appeals affirmed (App., *infra,* 1a-14a). Like the Tax Court, the court of appeals approached the case as requiring it to choose between *Wright* and *Shimberg* (see App., *infra,* 8a). The court first concluded that the dividend determination was to be made by importing into the reorganization context the principles applicable to redemptions under Section 302 of the Code (App., *infra,* 3a-6a). The court then concluded that the tests of Section 302 should be applied as if there had been a hypothetical redemption after the reorganization was

[5] Under the "safe harbor" provisions of Section 302(b)(2), cash received upon a "subtantially disproportionate redemption" will not be treated as a dividend. The statute defines such a redemption as one in which the shareholder's percentage interest in voting stock in the corporation following the redemption is less than 80% of what it was before the redemption and he retains less than 50% of the voting power in the corporation following the redemption.

completed, and hence that whether the cash payment was a dividend turned on the extent of the reduction in respondent's interest in NL occasioned by the hypothetical redemption (App., *infra,* 7a-11a). The court criticized the *Shimberg* approach of treating the cash payment as being made by the acquired corporation (App., *infra,* 10a-14a), stating, inter alia, that it failed adequately to consider "the corporate control he retained after the reorganization was completed" (*id.* at 10a-11a).

REASONS FOR GRANTING THE PETITION

The court of appeals' decision in this case has created a clear conflict in the circuits with respect to the treatment under Section 356(a)(2) of the Code of cash or other property received in a reorganization. This conflict, if allowed to persist, will create severe administrative problems for the Internal Revenue Service. Depending on their situation, different types of shareholders have different preferences for the treatment of the cash that they receive in a reorganization. Accordingly, regardless of which of the court of appeals decisions that it follows, the IRS can expect some taxpayers to challenge its treatment. Unless the conflict is resolved, therefore, the issue presented here is destined to remain a continual source of dispute and litigation. Moreover, the decision below unjustifiably departs from a long line of contrary authority on a recurring issue on which there are frequently large sums of money at stake. For these reasons, it is appropriate for this Court to grant certiorari to resolve the conflict.

1. There can be no doubt that the decision below directly conflicts with *Shimberg* v. *United States,* 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979). As the Tax Court noted (App., *infra,* 27a), *Shimberg* involved "a factual set of circumstances similar to the instant case," and there is no principled basis for reaching a different result in the two cases. In *Shimberg* a smaller corporation was merged into a larger one, and the shareholders of the acquired corporation received shares in the acquiring corporation, plus $625,000 in cash, to be allocated among the shareholders on a pro rata basis. Shimberg, who owned a majority of the shares of stock in the acquired corporation, reported his share of the cash received as long-term captial gain, but the Commissioner determined that it should be taxed as a dividend.

The court of appeals in *Shimberg* rejected the taxpayer's contention that redemption principles—namely, whether receipt of the cash in a hypothetical redemption of his shares in the acquiring corporation would have resulted in a meaningful reduction of his interest in that corporation—should be applied to determine whether the cash was equivalent to a dividend. The court stated (577 F.2d at 287 (footnote omitted)): "We agree with the government that 'the undifferentiating invocation of stock redemption principles in a reorganization case' such as this one is erroneous, and we decline to apply on a wholesale basis the 'meaningful reduction' test in cases arising under §356(a)(2)." Rather, the court explained, a "dividend" is generally defined by Section 316(a) of the Code as "any distribution of property made by a corporation to its shareholders * * * out of its earnings and profits." Accordingly, "[i]f a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a 'continuance of the proprietary interests in the continuing enterprise under modified corporate form,' it follows that the pro rata distribution of 'boot' to shareholders of one of the participating corporations must certainly have the 'effect of the distribution of a dividend' within the meaning of § 356(a)(2)." The court concluded that "§ 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred." 577 F.2d at 288.

It is evident that the holding of *Shimberg* is precisely the contention that was rejected here, and, as the court of appeals apparently recognized (see App., *infra,* 7a-8a, 13a-14a), the two decisions are irreconcilable. Moreover, the decision below also conflicts with the decisions of other courts of appeals relied upon in *Shimberg* (see 577 F.2d at 288) that recognized the appropriateness of dividend treatment in situations parallel to that presented here. See, *e.g., King Enterprises, Inc.* v. *United States,* 418 F.2d 511, 521 (Ct. Cl. 1969); *Hawkinson* v. *Commissioner,* 235 F.2d 747, 751 (2d Cir. 1956); *Campbell* v. *Commissioner,* 144 F.2d 177, 181-182 (3d Cir. 1944); see pages 14-16, *infra.* Thus, unless the Court grants certiorari here, different taxpayers will receive disparate tax treatment on the same transaction depending upon the circuit in which their case arises.

2. The conflict in the circuits created by the decision below will create substantial administrative problems for the IRS unless it is resolved. The issue presented here is one on which the respective interests of individual shareholders and corporate shareholders have long been sharply divergent. At least since 1936, because of the tax advantages of capital gains as opposed to ordinary income, it has been in the interest of individual shareholders, like respondents, not to have dividend treatment for gain recognized on boot received on a reorganization. On the other hand, corporate shareholders participating in the same or similar transactions have preferred to have such gain treated as a dividend, because of the deduction for intercorporate dividends allowed by Section 243 of the Code (generally 85% under present law). Thus, even if the Commissioner were to abandon his longstanding position on this issue and were to adopt the approach taken by the court below, that would not put an end to the controversy over the treatment of boot. It can reasonably be anticipated that corporate shareholders,

relying on *Shimberg* and the cases cited therein, would challenge the Commissioner's new position and argue for dividend treatment. Thus, the only way to end the controversy over the issue presented in this case is by means of a definitive resolution of the conflict in the circuits.

In the wake of the Tax Reform Act of 1986, which eliminated the differential tax rates between capital gains and ordinary income, one can expect a significant diminution in the number of individual shareholders whose interests will be adversely affected by dividend treatment of boot.[6] There will, however, remain shareholders in this category; individuals who have, or can carry forward, capital losses on other transactions will want their gain in a reorganization to be classified as capital gain, rather than as a dividend, so that they will be able to take a full deduction for the capital losses (see I.R.C. § 1211(b)). The 1986 Act will not affect the interests of corporate shareholders. Because of the intercorporate dividend deduction, they retain the same interest in contesting any effort by the Commissioner to deny dividend treatment to gain recognized on boot received in a reorganization.

Moreover, quite apart from the question of the characterization of the gain recognized by the shareholders of the acquired corporation, the conflict in the circuits injects considerable uncertainty into the treatment of other important tax accounts. The court below has held that "the boot should be characterized as a post-reorganization stock redemption by N.L." (App., *infra,* 7a). If that characterization is followed, it would necessitate several

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[6] Congress, however, apparently viewed the elimination of the differential tax rates for capital gain and ordinary income, which had been part of the revenue laws since 1921, as something of an experiment. Congress stated that it was retaining the existing statutory structure for capital gains in the Code in order "to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase." H.R. Rep. 99-841, 99th Cong., 2d Sess. Pt. II, at 106 (1986).

adjustments because, as discussed in detail *infra* (at 21-22), the receipt of additional stock that is subsequently redeemed has different collateral consequences from the receipt of boot. The receipt of additional shares in the transaction, which has the effect of spreading thinner the total basis transferred from the surrendered shares, means that the basis of each individual share retained after the merger would be smaller than if the boot were characterized as a dividend. And because the gain recognized on a redemption is reduced by the basis of the redeemed shares, the gain recognized in the merger will be different depending on whether the boot is characterized as a post-reorganization redemption. See pages 21-22, *infra*.

The disparities created by the conflict are even more pronounced in connection with the earnings and profits accounts. Under Section 356(a)(2) dividend treatment, the accumulated earnings and profits of the acquired corporation would be depleted by the amount of the dividend, and those earnings and profits would not be available for future dividends issued by the reorganized entity. On the other hand, if the boot is treated as coming from a hypothetical post-reorganization redemption, the earnings and profits of the acquired corporation ought to survive in the reorganized entity. Instead, the redemption presumably would draw upon the earnings and profits of the corporation whose stock was being redeemed; on the facts of this case, for example, that would lead to a substantially different post-reorganization earnings and profits structure (see pages 21-22, *infra*).[7] Thus, the difference between treating the boot as a dividend issued by the acquired corporation, on the one hand, and as a hypothetical post-reorganization redemption, on the other, may be reflected in continuing accounts, like basis and earnings and profits, that will have tax effects—and may lead to disputes—many years after the reorganization is complete.[8] Accordingly, it is of considerable importance for the Commissioner to know at the outset how to treat these transactions and to be able to apply a uniform rule nationwide. In sum, the 1986 Act does not eliminate the need to resolve the conflict in the circuits in order to permit the Commissioner to avoid an administrative quandary.

[7] Moreover, if the transaction is truly to be treated as a redemption, there would be additional differences because a redemption may draw upon capital and upon both accumulated earnings and profits and also those for the taxable year, whereas a Section 356(a)(2) dividend draws only upon accumulated earnings and profits. See page 22, *infra*.

Moreover, while it is possible that litigation in this area will increase now that the Fourth Circuit has flatly rejected a published IRS position that has been accepted by several courts, it must be emphasized that the administrative difficulties caused by this conflict would not be restricted to the litigation arena. The area of corporate reorganizations is one that involves considerable planning and often includes a request for a private letter ruling from the IRS. The IRS reports that it has issued 190 letter rulings since 1982 on reorganizations involving boot; 110 of these contained explicit rulings on treatment of boot under Section 356(a)(2). Each ruling for a particular reorganization will be applicable to an undisclosed, often large, number of shareholders. And a single reorganization may involve both corporate and individual shareholders, whose interests will likely be at odds, and shareholders who reside in different circuits, where the precedent governing the treatment of boot is irreconcilable. It is essential for the IRS to have a uniform rule to apply in issuing these rulings.

[8] See, *e.g.*, *Commissioner* v. *Phipps*, 336 U.S. 410 (1949); *Commissioner* v. *Munter*, 331 U.S. 210 (1947); *Foster* v. *United States*, 303 U.S. 118 (1938).

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3. The court of appeals erred in refusing to treat the boot received by respondents as a dividend. Section 316 of the Code provides that "the term 'dividend' means any distribution of property made by a corporation to its shareholders (1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the taxable year * * *." It further provides that "[e]xcept as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof * * *." Section 317 in turn defines "property" for these purposes as "money, securities, and any other property." The Court summarized the effect of these provisions as follows (*Commissioner* v. *Gordon,* 391 U.S. 83, 88-89 (1968) (footnote omitted)):

> Under §§ 301 and 316 of the Code, and subject to the specific exceptions and qualifications provided in the Code, any distribution of property by a corporation to its shareholders out of accumulated earnings and profits is a dividend taxable to the shareholders as ordinary income. Every distribution of corporate property, again except as otherwise specifically provided, "is made out of earnings and profits to the extent thereof."

The reorganization provisions of the Code have their origin in the Revenue Act of 1921, ch. 136, 42 Stat. 227. In order to "permit business to go forward with the readjustments required by existing conditions without the immediate imposition of taxes" (S. Rep. 275, 67th Cong., 1st Sess. 11 (1921)), Section 202(c)(2) of that Act (42 Stat. 230) provided that no gain or loss should be recognized upon an exchange of stock or securities in one corporation that is a party to the reorganization for stock or securities in another corporation that is a party to the reorganization. Section 202(d)(1) (42 Stat. 230) instead provides that the stock or securities received on the exchange should take the same basis in the hands of the taxpayer as the surrendered stock or securities. This statutory structure (now codified in I.R.C. §§ 354, 358 and 368) embodies the principle that such a stock-for-stock reorganization is "a continuance of the proprietary interests in the continuing enterprise under modified corporate form" (*Lewis* v. *Commissioner,* 176 F.2d 646, 648 (1st Cir. 1949)). See also Treas. Reg. § 1.368-1(b).

In 1924, Congress refined the reorganization provisions that it had enacted three years earlier by addressing the treatment of a payment of cash, in addition to the stock or securities received tax-free, to the shareholders of one of the reorganizing corporations. It enacted the predecessor to Section 356(a) of the Code, Section 203(d) of the Revenue Act of 1924, ch. 234, 43 Stat. 257, which provided that (1) if, in addition to eligible stock or securities, money or other property was received on a reorganization exchange, gain should be recognized to the extent of that money or other property, but (2) if such a distribution "has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee" the amount of the gain that does not exceed his share of undistributed earnings and profits. Congress indicated that this provision was necessary to account accurately for distributions in the context of a reorganization that had the same effect "as if the corporation had declared out [the cash] as a dividend" directly without the reorganization. See H.R. Rep. 179, 68th Cong., 1st Sess. 15-16 (1924); S. Rep. 398, 68th Cong., 1st Sess. 15-16 (1924).

The logical import of all of these provisions is that boot in a reorganization that is distributed pro rata to the shareholders of one of the corporations should be treated as a dividend. A pro rata distribution of cash from a corporation to its shareholders is the classical form of dividend. And the reorganization provisions are designed to reflect the fact that the new corporation is a continuation of the same enterprise of the acquired corporation. Accordingly,

the pro rata "distribution of property" made in the course of the reorganization to the shareholders of one of the corporations almost falls within the specific terms of the definition of "dividend" in Section 316 and should be viewed as "essentially equivalent to a dividend" within the meaning of Section 356(a)(2).

In this vein, a long line of court of appeals' decisions in the wake of the 1924 Act recognized that, where two corporations not previously under common control are unified either by statutory merger or consolidation (I.R.C. § 368(a)(1)(A)) or by the transfer of substantially all of the assets of one to the other in exchange for voting stock of the latter (I.R.C. § 368(a)(1)(C)), and the shareholders of one or both corporations receive a pro rata payment of cash, that payment has the effect of a dividend and is to be taxed as such. The first case in this line is *Commissioner* v. *Owens,* 69 F.2d 597 (5th Cir. 1934), where two banks merged and the shareholders of the smaller bank received pro rata both stock in the new bank and cash. The court held that "so much of [the cash] as might before consolidating have been declared by their corporation as an ordinary dividend out of its profits is by [the predecessor of Section 356(a)(2)] to be so taxed" (69 F.2d at 598). The court specifically noted (*ibid.*): "It is true that the money was not distributed by the [acquired bank] and thus was not literally a dividend of that bank. But the statute speaks of a distribution which 'has the effect of the distribution of a dividend.' This pro rata payment to all stockholders of the [acquired bank] * * * certainly has that effect."

Subsequent to *Owens,* several other courts of appeals reached the same conclusion regarding boot received on a pro rata basis. See *King Enterprises, Inc.* v. *United States,* 418 F.2d at 521 ("The distribution on a pro rata basis, entailing no substantially disproportionate change in the continuing equity interests of the Tenco stockholders, constitutes a classic example of a transaction having the effect

of the distribution of a dividend."); *Hawkinson* v. *Commissioner,* 235 F.2d at 751 ("the distribution had all the earmarks of a taxable dividend, i.e., a pro rata distribution out of corporate earnings and profits"); *Campbell* v. *Commissioner,* 144 F.2d at 182 ("We [previously] held that when cash was distributed in a reorganization to the stock holders of the predecessor company that part of the amount thus distributed which equalled the accumulated earnings of the predecessor corporation had the effect of a taxable dividend and was accordingly taxable as such."); see also *Ross* v. *United States,* 173 F. Supp. 793, 798 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959); *Rose* v. *Little Investment Co.,* 86 F.2d 50 (5th Cir. 1936); *Commissioner* v. *Forhan Realty Corp.,* 75 F.2d 268 (2d Cir. 1935); *Sheldon* v. *Commissioner,* 6 T.C. 510 (1946); *Woodward* v. *Commissioner,* 30 B.T.A. 1216, 1229-1230 (1934); *Woodward* v. *Commissioner,* 23 B.T.A. 1259 (1931).[9] On the other hand, where the cash payment was not pro rata to the shareholders of one of the corporations, but rather was made only to holders of preferred stock who did not own any common stock in order to call and retire that preferred stock, the payment was held not to have the effect of a

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[9] All of these cases, like the present one, involve "A" or "C" reorganizations of corporations not under common control. There are many more cases requiring dividend treatment for boot received in a "D" reorganization ("a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders * * * is in control of the corporation to which the assets are transferred," I.R.C. § 368 (a)(1)(D)). See, *e.g., DeGroff* v. *Commissioner,* 444 F.2d 1385 (10th Cir. 1971); *Liddon* v. *Commissioner,* 230 F.2d 304 (6th Cir.), cert. denied, 352 U.S. 824 (1956); *Lewis* v. *Commissioner,* 176 F.2d 646 (1st Cir. 1949); *Love* v. *Commissioner,* 113 F.2d 236 (3d Cir. 1940); cf. *Pridemark, Inc.* v. *Commissioner,* 345 F.2d 35 (4th Cir. 1965).

dividend. *Idaho Power Co.* v. *United States,* 161 F. Supp. 807 (Ct. Cl.), cert. denied, 358 U.S. 832 (1958). This line of authority was capped by *Shimberg* v. *United States, supra,* which rejected the precise contention accepted by the court below (see pages 6-8, *supra*). See also *General Housewares Corp.* v. *United States,* 615 F.2d 1056, 1066 (5th Cir. 1980).[10]

Indeed, the existence of this established line of authority was noted approvingly by this Court in *Commissioner* v. *Estate of Bedford,* 325 U.S. 283 (1945). That case dealt with a factual situation somewhat different from the one here. The estate in *Bedford* was a shareholder of a corporation that engaged in a recapitalization or "E" reorganization. In exchange for 3,000 shares of preferred stock, the estate received 3,500 shares of a lesser preferred, 1,500 shares of common stock, and $45,240 in cash. The Court held that the cash came out of the corporation's accumulated earnings and hence had the effect of a dividend and was taxable at ordinary, rather than capital, gain rates. The court referred with approval to several of the cases cited above requiring dividend treatment in the case of reorganizations involving two corporations, and it stated (*id.* at 291): "We cannot distinguish the two situations and find no implication in the statute restricting [the predecessor of Section 356(a)(2)] to taxation as a dividend

[10] These cases uniformly recognize that dividend treatment does not turn upon which corporation physically pays out the cash to the shareholders. Whether the immediate source of the cash is the acquiring corporation, the acquired corporation, or the new corporation, a pro rata distribution to the shareholders of one corporation is a dividend to the extent of the accumulated earnings and profits of that latter corporation. See *Shimberg* v. *United States,* 577 F.2d at 289; *Ross* v. *United States,* 173 F. Supp. at 798; *Campbell* v. *Commissioner,* 144 F.2d at 182; *Commissioner* v. *Owens,* 69 F.2d at 598; *Woodward* v. *Commissioner,* 23 B.T.A. at 1362.

only in the case of an exchange of stock and assets of two corporations." [11]

Against this uniform body of decisional law, the court below erroneously relied upon *Wright* v. *United States,* 482 F.2d 600 (8th Cir. 1973), which arose in a very different factual context. Wright was the principal shareholder in three different corporations engaged in construction and equipment leasing. Wright owned 71.5% of the stock of the construction company, and his field superintendent owned 27.9%. They wanted to merge the other two companies and create a new company (Omni) that would have a stock ownership ratio similar to that of the construction company. A simple stock-for-stock reorganization, however, would have given Wright a greater share of Omni than he desired. Therefore, the merger plan provided that, in addition to the exchange of

[11] In the course of rejecting an alternative argument made by the estate, the Court made the statement that "a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' " (325 U.S. at 292). This statement was read by some as establishing an "automatic dividend" rule that would accord dividend treatment to any cash received on a reorganization, whether pro rata or not. This "automatic dividend" rule was heavily criticized by the commentators (see, *e.g.*, Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule,* 20 Tax L. Rev. 573 (1965); Darrell, *The Scope of* Commissioner *v.* Bedford Estate, 24 Taxes 266, 268-276 (1946)). The post-*Bedford* cases in this area, however, have rejected this broad reading and have concluded that this Court was not attempting to establish a rule that would extend to cases not involving a pro rata distribution, which was not what was involved in *Bedford.* See *Shimberg* v. *United States,* 577 F.2d at 290 & n.19; *King Enterprises, Inc.* v. *United States,* 418 F.2d at 520; *Hawkinson* v. *Commissioner,* 235 F.2d at 750-751; *Ross* v. *United States,* 173 F. Supp. at 797. The IRS has also rejected this broad reading of *Bedford.* See Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121. Because the present case involves a pro rata distribution of boot, the court of appeals erred in suggesting (App., *infra,* 11a-12a) that the government's contention here seeks to "resurrect[ ] the abandoned automatic dividend rule of *Bedford.*"

stock in the two old companies for stock in Omni, the superintendent would purchase additional shares of Omni and Omni would issue a promissory note to Wright. This promissory note was boot, and the court of appeals rejected the Commissioner's contention that it had the effect of a dividend. The court noted that "[t]he corporations involved did not exist separately but were owned and controlled by the same shareholders but in different proportions" (*id.* at 607). On that basis, the court concluded that "the note was issued by Omni in exchange for a portion of Omni stock that the taxpayer would have received if he had taken Omni stock entirely instead of receiving Omni stock and a note issued to him by Omni" (*ibid.*). The court then applied the provisions of Section 302 to measure the effect of this hypothetical redemption on Wright's interest in Omni and concluded that there was a meaningful reduction in his percentage interest that precluded dividend treatment.

The Fifth Circuit in *Shimberg* recognized that *Wright* was distinguishable because the commonality of ownership of the merging corporations appeared to be the basis upon which the Eighth Circuit had concluded that the distribution of boot should be treated like a redemption of shares in a single corporation. The Fifth Circuit therefore remarked (577 F.2d at 287): "Even assuming that *Wright* is correctly decided—a point on which we express no opinion—the instant case presents radically different facts and calls for correspondingly different analysis." That observation is equally applicable here. For this reason, the court of appeals below clearly erred in applying the "hypothetical redemption" approach of *Wright* to this case, rather than the long line of authority requiring dividend treatment for boot distributed to the shareholders of one corporation on a pro rata basis.

4. In the words of the Fifth Circuit in *Shimberg*, it was error for the court below to embrace "the undifferentiating invocation of stock redemption principles in a reorganization case such as this one" (577 F.2d at 287). To be sure, there is considerable similarity between the redemption provisions and Section 356(a)(2) ~~and the redemption context~~; both involve an inquiry into whether a particular non-dividend distribution is sufficiently akin to a dividend that it should be treated as one for tax purposes. At the same time, there are significant differences between the two contexts to which these provisions apply—for example, the difference between a transaction involving a shareholder and a single corporation as opposed to a consolidation involving two, often unrelated, corporations. These differences are substantial enough to counsel against the incorporation of every nuance and detail of Section 302 into the inquiry needed under Section 356(a)(2).

In any event, in the context presented here, there is no tension between the principles of Section 302 and the principles that should be applied under Section 356(a)(2). As discussed above, a pro rata payment of boot should be treated as a dividend. A distribution to a sole shareholder, as in this case, is necessarily pro rata. By the same token, a pro rata redemption of stock, including the redemption of some of the shares of a sole stockholder, is essentially equivalent to a dividend and therefore taxable as a dividend under Section 302(d). See *United States* v. *Davis*, 397 U.S. 301 (1970). In short, a pro rata payment of cash is the prototype transaction calling for dividend treatment in both the reorganization and redemption contexts. This case, therefore, presents no occasion to consider to what extent the detailed formulations of Section 302 should be applicable in the case of boot that is not distributed on a pro rata basis or whether, in such circumstances, a different result could obtain under Section 356(a)(2) from what would be indicated by Section 302.[12]

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[12] The court in *Shimberg* noted that it did not totally reject the relevance of redemption principles in the context of a reorganization (577

The court below concluded that the application of redemption principles in the post-reorganization setting yielded capital gain treatment of boot distributed to a sole shareholder. It could reach this conclusion only by assuming, contrary to fact, that respondent had elected the choice that he consciously rejected, namely, receiving, 425,000 shares of NL stock and no cash. The court then applied Section 302 to the hypothetical redemption of 125,000 of those shares and concluded that the diminution in respondent's interest in NL was sufficiently substantial to make the redemption (and hence the receipt of boot) not equivalent to a dividend.

This approach is seriously flawed. First, it is generally true that, "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice," not of the alternative that he did not choose. *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). See also *Don E. Williams Co.* v. *Commissioner*, 429 U.S. 569, 579-580 (1977). In addition, the approach of the court below creates substantial practical difficulties because it requires a determination of how many shares the taxpayer would have received instead of the boot if the transaction had been a stock-for-stock reorganization followed by a redemption. That determination happened to be easy in this case because of the fortuity that respondent had been offered two alternatives. In cases that lack this unusual aspect, and that involve difficult-to-

F.2d at 290). By the same token, the Commissioner has stated that the principles developed under Section 302 for determining dividend equivalency may "in appropriate cases" serve as "useful guidelines for purposes of applying § 356(a)(2)." Rev. Rul. 74-516, 1974-2 C.B. 121. But these principles come into play only in the context of a non-pro-rata distribution; otherwise, the payment is clearly a dividend. Thus, they have no application here. For this reason, the example of a non-pro-rata distribution that the court of appeals put forth as demonstrating a flaw in the Commissioner's position (see App., *infra*, 12a) was quite irrelevant.

value close corporations, it will be quite difficult to construct the hypothetical redemption required by the court of appeals.

Moreover, the decision below is flawed because it seeks to equate two transactions that differ in a number of important respects. If respondent had actually elected to receive all of the consideration in the form of NL stock and then redeem a portion of it, the basic accounting figures generated by the transaction would not have been the same. The total basis of the stock received by respondent in the merger, which derives from the basis in the old stock he exchanged, must be allocated over the total number of shares received. Thus, the basis of each individual share obviously is going to be different depending upon whether the total basis is allocated over the 300,000 shares actually received in the merger or over the 425,000 shares that would have been received in the transaction assumed by the court of appeals. And, because the gain recognized on a redemption is reduced by the basis of the redeemed shares, the gain recognized if respondent had chosen the "no cash option" would have been different from the gain recognized on the actual transaction involving boot.

Another difference between the two transactions is the effect on the earnings and profits accounts. In the actual transaction, the earnings and profits available for distribution as a dividend were Basin's $2,319,611 in accumulated earnings and profits. If respondent had chosen the redemption option, however, the earnings and profits would have been those of NL (a figure that is not in the record here and that, in any event, bears no relation to Basin's or respondent's history).[13] And the effect on earnings and profits is not the same under Section 356(a)(2) as

[13] Because Basin did not merge into NL, but rather into its subsidiary, NLAC, Basin's earnings and profits would not be involved in the redemption of NL stock.

it is in the case of redemptions. In the former case, the statute specifically provides that the available account is limited to *accumulated* earnings and profits. In the case of a redemption, the earnings and profits of the taxable year are also available (see *Estate of Uris* v. *Commissioner,* 605 F.2d 1258 (2d Cir. 1979); *Baker* v. *United States,* 460 F.2d 827, 832-835 (8th Cir. 1972)), and a portion of the redemption would have drawn upon a share of NL's capital (see *Foster* v. *United States,* 303 U.S. 118 (1938)). These significant differences cast considerable doubt upon the validity of a doctrine that assumes that the two transactions are equivalent.

In sum, respondent presumably acted prudently and according to his best judgment in choosing to take cash and stock upon the merger of his corporation into NLAC, rather than committing substantially all of his resources to a large corporation in which he would be a minority shareholder (see note 2, *supra*). The court below erred in relieving him of the tax consequences of that choice and instead giving him the tax consequences of the option that he declined. The court should have followed established precedent and treated the boot actually received as a dividend to the extent of Basin's earnings and profits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

DONALD B. AYER
*Acting Solicitor General**

WILLIAM S. ROSE, JR.
Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALAN I. HOROWITZ
Assistant to the Solicitor General

ERNEST J. BROWN
Attorney

JANUARY 1988

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* The Solicitor General is disqualified in this case.

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 86-1736

DONALD E. CLARK; PEGGY S. CLARK, PLAINTIFF-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE,
DEFENDANT-APPELLANT

Appeal from the United States Tax Court. Judge Tannenwald, Tax Court Judge. (Tax Ct. No. 9428-83)

Argued: June 3, 1987
Decided: September 4, 1987

Before: HALL and WILKINSON, Circuit Judges, and SMALKIN, United States District Judge for the District of Maryland, sitting by designation.

WILKINSON, Circuit Judge:

In April 1979, Donald Clark sold his company to N.L. Industries for 300,000 shares of N.L. stock and $3,250,000 in a transaction that qualified as a reorganization. The issue in this case is whether the cash payment, commonly called boot, should be taxed as a capital gain or as ordinary income. The Commissioner treated the boot as ordinary income, characterizing it as a dividend paid by Clark's company immediately before the reorganization. This characterization, however, fails to recognize that the

cash was an integral part of the reorganization. Rather than artifically separating the stock and the cash portions of the reorganization, we must examine the transaction in its entirety. We regard the boot as a cash payment by N.L. in return for Clark's relinquishment of a portion of his interest in the newly reorganized corporation. Because Clark surrendered more than 20% of his interest in N.L., he is entitled to capital gain treatment.

I.

Clark was the sole shareholder of Basin, a West Virginia corporation that supplied electronic, radiation, and nuclear open-hole logging services to the petroleum industry. In 1978, N.L. Industries, a public company listed on the New York Stock Exchange, initiated negotiations with Clark over the possible acquisition of Basin. N.L. eventually offered to buy Clark's stock for either 425,000 shares of N.L. or 300,000 shares and $3,250,000. Clark accepted the combination offer.

In April 1979, Clark and N.L. finalized the deal by signing an agreement in which Basin was merged with NLAC, a subsidiary of N.L. created for acquisition purposes. Because Clark and the Commissioner have stipulated that the transaction qualified as a reorganization under 26 U.S.C. § 368(a)(1)(A) and § 368(a)(2)(D), Clark did not have to report any gain on the exchange of his Basin stock for N.L. stock. Section 356(a), however, requires Clark to pay tax on the $3,250,000 cash payment to the extent of his gain in the transaction.

Clark and the Commissioner disagree on whether the cash payment should be taxed as a capital gain or ordinary income. Clark reported the boot as capital gain, but the Commissioner found that the cash payment had the effect of a dividend and should be taxed as ordinary income

to the extent of Clark's ratable share in Basin's earnings and profits. After the Service assessed a deficiency of $972,504.74, Clark filed a petition with the Tax Court. In a unanimous reviewed opinion, the Tax Court held that the corporate boot should be treated as a capital gain. *Clark v. Commissioner*, 86 T.C. 138 (1986). The Commissioner appeals.

II.

According to § 356(a)(2), cash received during a reorganization is considered ordinary income if it has the effect of a dividend. In determining when corporate boot has the effect of a dividend, most courts have relied on the principle of § 302, which provides in part that a corporate distribution is a dividend unless the shareholder relinquished more than 20% of his corporate control and was less than a 50% shareholder after the transaction. Although the Commissioner notes several differences between § 302 and § 356, we believe that § 302 continues to provide the appropriate test for determining whether boot is ordinary income or a capital gain. Thus, if Clark surrendered more than 20% of his corporate interest in return for the cash payment, he is entitled to capital gain treatment.

Under § 356(a)(2), Clark must recognize the boot as ordinary income if it had the "effect of the distribution of a dividend." Section 356 does not define when a payment has the effect of a dividend. In *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), the Supreme Court initially suggested that any cash payment made during a reorganization would be treated as a dividend under § 356. This automatic dividend rule, however, was severely criticized by the commentators. *See, e.g.*, Darrel, *The Scope of Commissioner v. Estate of Bedford*, 24 Taxes 266 (1946);

Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 Tax L. Rev. 573 (1965). The lower courts retreated from this absolute approach, *see*, e.g., *Hawkins v. Commissioner*, 235 F.2d 747, 750-51 (2d Cir. 1956); *King Enterprises, Inc. v. United States*, 418 F.2d 511, 520 (Ct. Cl. 1969); *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl. 1958), and the Commissioner eventually abandoned the *Bedford* approach in several revenue rulings. *See, e.g.*, Rev. Rul. 515, 1974-2 C.B. 118; Rev. Rul. 83, 1975-1 C.B. 112. In place of this automatic dividend rule, most courts have approached the corporate boot problem by focusing on the underlying principle of § 302.

Although § 302 deals with stock redemptions by a single corporation, the section does draw a fundamental distinction between a capital gain and ordinary income. The basic principle of § 302 is that a shareholder who receives cash in a pro rata corporate distribution must pay an ordinary income tax, but if the shareholder relinquishes a sufficient portion of his corporate control in return for the cash, he will receive capital gain treatment. *See* 11 U.S.C. § 302 (1982); *See also United States v. Davis*, 397 U.S. 301 (1970) (requiring capital gain treatment if the redemption caused a "meaningful reduction" in the shareholder's corporate control).

When a shareholder surrenders some corporate control in return for a cash distribution, he is entitled to capital gain rates because the transaction is essentially an exchange of his corporate control, rather than a simple pro rata distribution of corporate earnings and profits. Because it is difficult to determine when a shareholder has yielded a sufficient percentage of control, § 302(b) contains a safe harbor provision, which treats a redemption as a capital gain if the taxpayer surrendered more than 20% of his corporate interest and was not a majority shareholder, after the redemption. If the principle of § 302 applies in this case, the boot would be a capital gain only if Clark yielded a sufficient portion of his corporate control.

Section 302 does not explicitly apply in the reorganization context, but there are several persuasive reasons why § 302 should be used in determining whether boot is taxed as ordinary income. Sections 302 and 356 contain virtually identical language, with § 302 providing for ordinary income treatment if the redemption is "essentially equivalent to a dividend", while § 356 treats boot as ordinary income if it "has the effect of a distribution of a dividend." Based on this similarity, the courts have consistently held that the sections should be read *in pari materia*. *See, e.g., Wright v. United States*, 482 F.2d 600, 605 (8th Cir. 1973); *Hawkins*, 235 F.2d at 750; *Ross v. United States*, 173 F. Supp 793, 797 (Ct. Cl. 1959). *See also Shimberg v. United States*, 577 F.2d 283, 287 n.13 (5th Cir. 1978) (stating that § 302 applies in "appropriate cases.") Moreover, in discussing the Deficit Reduction Act of 1984, the House and Senate conference committee noted that the "principles of section 302 are applicable in testing for dividend equivalence under section 356." H. Rep. 861, 98th Cong., 2d Sess. 757, 845, reprinted in 1984 U.S. Code Cong. & Ad. News 1445, 1532. Most importantly, § 302 and § 356 address the same issue: when should a corporate distribution be treated as a dividend? Note, *Reorganization and Capital Gains—A Forgotten Concept?*, 41 U. Pitt. L. Rev. 291 (1980); Note, *Determining Dividend Equivalence of "Boot" Received in a Corporate Reorganization*, 32 Tax Lawyer 834 (1979).

Until this case, the Commissioner has apparently adopted the prevailing view that § 302 applies in the reorganization setting. *See, e.g., Wright*, 482 F.2d at 605; Rev. Rul. 515, 1974-2 C.B. 118; Rev. Rul. 83, 1975-1 C.B. 112. The Commissioner, however, has discovered several

differences between the two sections and now argues that § 302 does not apply. For example, the Commissioner notes that all cash received in a stock redemption is ultimately taxed at either capital gain or ordinary income rates, but the boot received in a reorganization is taxed only to the extent of the taxpayer's gain on the transaction, regardless of the size of the boot payment. In addition, if a redemption is a dividend under § 302, the shareholder must pay ordinary income to the full extent of the corporation's earnings and profits (E&P), but if the boot is a dividend, § 356 only requires the shareholder to pay ordinary income to the extent of his ratable share of the corporate E&P.

While the Commissioner has illustrated several important differences between the two sections, they are irrelevant in this case. As Clark notes, the differences relate only to the *amount* of the gain treated as a dividend, not to the *character* of the corporate distribution. Any potential problems created by the differences in the provisions can be avoided by using § 302 only to determine whether the boot had the effect of a dividend and relying on § 356 to evaluate what specific portion of the payment, if any, should be taxed as ordinary income. In return for abandoning the § 302 analysis, the Commissioner offers no realistic alternative, except perhaps a return to the abandoned rule that any pro rata distribution in a reorganization must automatically be treated as a dividend. Rather than ignore a code section that specifically addresses the same problem as § 356, we join the long line of courts that have applied § 302 in the reorganization context. *See, e.g., Wright*, 482 F.2d at 605; *Hawkins*, 235 F.2d at 751; *King Enterprises*, 418 F.2d at 520-21.

III.

Although § 302 provides that a boot payment is a capital gain if Clark relinquished enough corporate control, the section cannot resolve this case. The boot can be seen as affecting either Clark's interest in Basin or in N.L., with radically different tax treatment depending on whether the boot was paid before or after the reorganization. Because § 302 was designed to deal with a stock redemption by a single corporation, rather than a reorganization involving two companies, the section does not indicate which corporation Clark actually lost interest in. Based on the language and legislative history of § 356, the change-in-ownership principle of § 302, and the need to review the reorganization as an integrated transaction, we conclude that the boot should be characterized as a post-reorganization stock redemption by N.L. that affected Clark's interest in the new corporation. Because this redemption reduced Clark's N.L. holdings by more than 20%, the boot should be taxed as a capital gain.

The transaction in this case involved two steps: Clark received a $3,250,000 corporate distribution and exchanged his Basin stock for N.L. stock. The characterization of the corporate boot presents a problem primarily because these two steps can be combined into at least two plausible stories. In the first version, Clark received the $3,250,000 from Basin in a pre-reorganization distribution and subsequently merged his shrunken company with N.L. for 300,000 shares. Under this pre-reorganization view, the boot would be ordinary income because Clark was the sole shareholder of Basin. In the second version, Clark exchanged his Basin stock for 425,000 shares of N.L. stock and N.L. subsequently redeemed 125,000 shares for $3,250,000. Because this redemption reduced Clark's interest in N.L. by almost 30%, he would be entitled to capital gain treatment.

Of course, both of these hypothetical stories are slightly unrealistic. In the pre-reorganization view, Basin is treated as distributing over three million dollars to Clark, but no such distribution occurred. Under the post-view, Clark is seen as receiving 425,000 N.L. shares, an offer he refused, and then hypothetically redeeming 125,000 shares. Despite the flaws in each story, they represent the only realistic options. No matter how the story is told, the boot was received either before or after the reorganization. If the boot was paid by Basin before the reorganization, the appropriate question is whether the payment affected Clark's ownership interest in Basin. If the boot was received after the reorganization, the focus should be on how it reduced Clark's holdings in N.L. Industries. Each version has its theoretical arguments and judicial adherents. *See Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978) applying pre-organization view); *Wright v. United States*, 482 F.2d 60 (8th Cir. 1973) (applying post-reorganization view).

In determining which view is more appropriate, the starting point of analysis is the statutory language of § 356. Section 356(a)(2) provides that, if the boot is a dividend, the shareholder is taxed at ordinary income rates only to "his ratable share of the undistributed earnings and profits of the corporation." The Commissioner argues that if the boot is deemed to come from N.L., Clark would have to determine his ratable share of N.L.'s earnings and profits (E&P), a task that is both difficult and slightly unrealistic. Moreover, if the focus is on the E&P of the acquirer, the shareholders of a target company could receive a distribution that has the effect of a dividend and pay virtually no ordinary income tax if the acquirer has a low E&P account. Thus, the Commissioner argues that "the corporation" in § 356(a)(2) must be Basin and hence that a pre-reorganization perspective is envisioned in the statute.

We do not think this statutory language is nearly so clear as the Commissioner suggests. In fact, much of the language of § 356 supports an integrated view of the transaction. Section 356(a)(1) provides that if the transaction would have been a tax-free reorganization "but for the fact that *the property received in the exchange* consists not only of property permitted by section 354 or 355 . . . but also of other property or money, then the gain, if any, to the receipient shall be recognized." 26 U.S.C. § 356(a)(1) (1982) (emphasis added). At a minimum, this language indicates that a shareholder of the target corporation may receive cash from the acquiring company; the section also strongly implies that all property involved in the reorganization, both the stock and the boot; should be seen as coming from the acquirer in a single exchange. Hankin & Lerer, *Wright v. Wrong: The Final Solution to the Dividend Equivalency Problem*, 23 Santa Clara L. Rev. 1 (1983). The Commissioner's pre-reorganization view conflicts with this language because it invariably sees the boot as coming from the target corporation, thereby separating the boot payment from the exchange of stock.

The post-reorganization view of the language of § 356 is bolstered by the legislative history. In enacting § 112(c)(2) of the 1939 Code, the precursor of § 356(a)(2), Congress provided an example of when a distribution has the "effect of a dividend." In the example, shareholders of corporation A tried to withdraw the company's E&P by forming corporation B, transferring all the assets of the old corporation to this new corporation in a reorganization, and receiving as consideration some stock of B plus a cash payment. H. Rep. 179, 68th Cong., 1st Sess 15 (1924), 1939-1 C.B. (Pt. 2) 241, 252. The boot in that case should obviously be treated as a dividend: the shareholders have received corporate earnings in a pro rata distribution while retaining the same level of control in corporation B. As the

Tax Court properly noted, this example suggests that "the primary objective of Congress was to prevent shareholders from bailing out earnings and profits at capital gain rates when in essence the shareholders stood substantially in the same position before the reorganization as they did after the reorganization." 86 T.C. at 143. There is no evidence of such a bail-out in this case.

We cannot accept the Commissioner's view of the legislative history. According to the Commissioner, Congress enacted § 356 to ensure that corporate boot would be taxed as ordinary income if the distribution would have been a dividend without the reorganization. The Commissioner concludes that Clark should pay an ordinary income tax, even though his corporate control was affected by an acquisitive reorganization, because the boot would have been a dividend if paid by Basin absent the reorganization. This reading of the legislative history is unsupportable; there is no indication that Congress intended to impose virtually automatic dividend treatment on boot received during an acquisitive reorganization in which the shareholder of the target corporation relinquished a portion of his interest in the new corporation. Note, *Taxation of Boot Distributions: A Return to Bedford?*, 7 Hofstra L. Rev. 987 (1979); Note, *Treatment of Cash Distributions to the Shareholders Pursuant to a Corporate Reorganization: Shimberg v. United States*, 20 B.C.L. Rev. 601 (1979).

The principles underlying § 302 also support the post-reorganization view. The critical inquiry under § 302 is whether Clark lost any corporate control as a result of the transaction. Under the Commissioner's view, Clark lost no control because, after the redemption, he was still the majority shareholder of Basin. This version, however, fails to recognize that Basin ceased to exist immediately after the hypothetical distribution to Clark. An examination of Clark's pre-reorganization interest in Basin reveals

nothing about how much corporate control he retained after the reorganization was completed. An accurate evaluation of Clark's corporate interest for purposes of § 302 requires an examination of his holdings in N.L., which is the continuing corporation. Hurley, *Capital Gain Possibilities for Boot in Acquisitive Reorganizations Lessened by Shimberg Case*, 50 J. Tax'n 334 (1979).

IV.

In addition to finding scant support in the language and legislative history of § 356 and the rationale of § 302, the Commissioner's version of the transaction suffers from several serious flaws. First, as a practical matter, the Commissioner's view inexplicably favors shareholders of corporations which merge with larger corporations. Milner, *Boot under the Senate Finance Committee's Reorganization Proposal: a Step in the Wright Direction, But Too Far*, 62 Taxes 507 (1984). When a shareholder merges with a corporation listed on a major stock exchange, he can avoid ordinary income and virtually ensure capital gain treatment by taking only stock from the acquirer, waiting a sufficiently long time, and then selling the stock on the market as a capital gain. Note, *Boot Hill—Characterizing Property Distributed with Corporate Reorganizations*, 4 J. Corp. Law. 711 (1979). If, on the other hand, a shareholder merges with a closely held company, he may be forced to choose between taking only stock or receiving some cash and paying an ordinary income tax.

Second, the Commissioner's view comes close to resurrecting the abandoned automatic dividend rule of *Bedford*. *See* Note, 20 B.C.L. Rev. 601 (1979). The Commissioner's view will result in ordinary income treatment in most reorganizations because corporate boot is usually distributed pro rata to the shareholders of the target corporation. In cases where the target company has only one

shareholder, the Commissioner's rule would go even further and virtually guarantee dividend treatment because cash distributed to a sole shareholder will almost never result in a loss of corporate control and thus will almost always be deemed a dividend. The statutory language in § 356 clearly does not impose such automatic dividend treatment.

Third, the Commissioner's pre-reorganization perspective leads to anomalous results in some cases. Even the adherents of that view admit that the approach may be inappropriate when an individual owns stock in both the target and the acquiring corporation, as the following example illustrates: Shareholder A owns 30 of the 100 shares of corporation X, which is worth $100, and holds all 100 shares of corporation Y, also worth $100. Corporation X merges with corporation Y, creating XY corporation, a new company worth $200. As consideration for the merger, Shareholder A receives 110 shares of XY stock plus $20, instead of the 130 shares of XY stock he would have received in a pure stock-for-stock reorganization. The remaining shareholders of Corporation X receive only XY stock. When the reorganization is finished, A owns 110 of the 180 shares of XY stock and has $20. *See, e.g.*, Note, *Boot Distributions in Acquisitive Reorganizations: The Wright-Shimberg Controversy*, 59 S. Cal. L. Rev. 1295 (1980).

Under the pre-reorganization view, A would pay capital gain on the boot because he will be treated as if he redeemed 20 of his 30 shares in Corporation X for $20, immediately before the reorganization, thus falling within the § 302 safe harbor provision. Shareholder A, however, should pay ordinary income because he is the majority shareholder of the reorganized corporation. The intergrated view, by focusing on A's post-reorganization interest in the new company, would properly impose an ordinary income tax.

Fourth, as the Tax Court recognized, the leading case for the Commissioner's view, *Shimberg v. United States*, misconstrued the comparisons of shareholder interests required under an integrated view of the reorganization. 86 T.C. at 148-49; Note, 32 Tax Lawyer 834. *Shimberg* involved a "minnow-whale" reorganization, in which a small corporation merged with a larger corporation. The district court held that the shareholder of the target company satisfied the safe harbor provision of § 302 because he went from being the majority shareholder of the target to a less than 1% shareholder in the acquirer. As the *Shimberg* court noted, this approach would lead to a virtual automatic capital gain rule in minnow-whale reorganizations because the target shareholders will invariably fall with the § 302 safe harbor provisions. *Shimberg*, 577 F.2d at 287-88.

The *Shimberg* court was wrong to suggest, however, that an integrated perspective automatically provides for capital gain treatment. Rather than comparing the shareholder's interest in the target with his interest in the acquirer, the integrated view focuses on the shareholder's loss of interest in the acquiring corporation. If the boot does not reduce his ownership interest in the surviving corporation by the amount required in § 302, the shareholder must pay ordinary income.

Finally, the Commissioner's view artificially segments the Basin-N.L. reorganization. The step transaction doctrine, which encourages the view of transactions in their entirety, confirms our view that an integrated perspective is more appropriate. The classic exposition of the doctrine is *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954), which also involved a choice between two plausible versions of a transaction. In *Zenz*, a shareholder redeemed a portion of his stock and sold the other portion to an outside buyer. The Commissioner argued that the redemption occurred first, which required the taxpayer to pay ordinary income

on the redemption. According to the taxpayer, the sale occurred first, which resulted in capital gain treatment for the redemption because it completely liquidated the shareholder's interest in the company. Both versions were theoretically plausible. *Zenz* noted that the overall effect of the sale and redemption was a complete elimination of the taxpayer's interest in the corporation, which should have entitled the taxpayer to a capital gain. 213 F.2d at 917. To ensure that the shareholder paid only capital gain rates, the court treated the transaction as if the sale occurred first, followed by a complete redemption.

This case presents the same problem faced by the *Zenz* court: determining which transaction—the redemption or the exchange of stock—occurred first. *Zenz* resolved the problem by focusing on the net effect of both steps in the transaction. The Commissioner here focuses on only one part of the transaction and fails to recognize that the cash and the stock exchange were integral parts of one reorganization. See, Levin, Adess & McGaffey, *Boot Distributions in Corporation Reorganizations*, 30 Tax Lawyer 287 (1977); Note, 59 S. Cal. L. Rev 1295; Note, 32 Tax Lawyer 834. The facts show that as a part of the reorganization, Clark was offered a choice between 125,000 shares of N.L. stock and $3,250,000. The cash that Clark chose was clearly a substitute for additional N.L. stock; the Tax Court found that "there is not the slightest evidence that the cash payment was a concealed distribution from Basin." 86 T.C. at 155.

The tax consequences of the transaction should reflect the reality of Clark's choice to forego 125,000 shares of N.L. stock. There is no question in this case that the value of the boot received was roughly equivalent to the value of the shares foregone by Clark. By taking the cash, Clark surrendered his potential interest in N.L. to the extent of almost 30%. This 30% drop satisfied the safe-harbor provisions of § 302 and entitled Clark to capital gain treatment.

The judgment of the Tax Court is *AFFIRMED.*

APPENDIX B

Docket No. 9428-83

DONALD E. CLARK AND PEGGY S. CLARK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Filed February 6, 1986

TANNENWALD, *Judge*: Respondent determined a deficiency in petitioners' Federal income taxes for the taxable year 1979 of $972,504.74. The sole issue for decision is whether the receipt by petitioners of cash (boot) as partial consideration under a plan of reorganization pursuant to sec. 368(a)(1)(A) and (a)(2)(D),[1] should be treated as a dividend pursuant to sec. 356(a)(2), instead of long-term capital gain under sec. 356(a)(1).

FINDINGS OF FACT

Some of the facts have been stipulated and are so found. This reference incorporates the stipulation of facts and attached exhibits.

Petitioners, husband and wife, resided in Buckhannon, West Virginia, at the time they filed their petition in this case. They timely filed a joint Federal income tax return for the calendar year 1979 with the Internal Revenue Service Center in Memphis, Tennessee.

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954 as amended and in effect during the year in issue, and all Rule references are to the Rules of Practice and Procedure of this Court.

For some time prior to April 18, 1979, petitioner husband Donald E. Clark (hereinafter referred to as petitioner) owned all the outstanding stock (58 shares) of Basin Surveys, Inc. (BASIN), a West Virginia corporation. BASIN's principal business was furnishing radiation, nuclear, and electronic open-hole logging services to the petroleum industry. Petitioner was the president of BASIN from 1964 until April 18. 1979.

N.L. Industries, Inc. (N.L.), is a New Jersey corporation engaged in the manufacturing and supplying of petroleum equipment and services, chemicals, and metals. NL is a publicly held corporation whose stock is traded on the New York Stock Exchange and the Pacific Stock Exchange. As of the end of March 1979, NL had outstanding approximately 32,533,000 shares of its single class of common stock (par value $2.50 per share) and 500,000 shares of preferred stock. N.L. Acquisition Corp. (NLAC) was a wholly owned subsidiary of NL.

In 1978, NL initiated discussions with petitioner regarding the possible acquisition of BASIN by NL. After several months of negotiations, on March 6, 1979, NL offered petitioner a choice between two alternatives: in exchange for petitioner's BASIN stock, NL was willing to give petitioner either (1) 425,000 share of NL common stock and no cash, or (2) a combination of 300,000 shares of common stock and $3,250,000 cash. Petitioner accepted NL's combined stock and cash offer. By accepting this offer, the total number of NL common shares outstanding increased to approximately 32,833,000 shares, and petitioner's stockholdings represented approximately 0.92 percent of that total. If petitioner had accepted the all-stock deal of 425,000 shares, the total number of NL common shares outstanding would have increased to approximately 32,958,000 shares, and petitioner's stockholdings would have represented approximately 1.3 percent of that total.

On April 3, 1979, an agreement and plan of merger (the plan) was executed by BASIN, NLAC, petitioner, and NL. The plan provided that on April 18, 1979, BASIN would merge with and into NLAC and that each outstanding share of NLAC would remain outstanding, each outstanding share of BASIN common stock would be exchanged for $56,034.482 cash and 5,172.4137 shares of NL common stock, and each share of BASIN common stock held in the treasury of BASIN would be canceled. The plan further provided that the articles of incorporation of NLAC would be amended to change its name to Basin Surveys, Inc. Moreover, pursuant to the plan, petitioner signed a covenant not to compete for 5 years and an employment agreement to remain with Basin Survey, Inc., for 3 years.

For the purposes of this case, the parties agree that the merger of BASIN into NLAC (the merger) was effected pursuant to, and qualified as a reorganization under, section 368(a)(1)(A) and (a)(2)(D). The closing price of NL common stock on the New York Exchange on April 18, 1979, was $23⅛ per share. Based on that closing price, the NL stock received by petitioner had a value of $6,937,500 which constituted 68.1 percent of the total value of the consideration which petitioner received for his BASIN stock. Prior to the merger, petitioners did not own any stock in NL or NLAC.

Petitioner's basis for his BASIN stock immediately prior to the merger was $84,515. He incurred expenses of $25,013 in connection with the merger. In their joint Federal income tax return for 1979, petitioners reported recognition of $3,195,294 of long-term capital gain as a result of the merger. As of April 18, 1979, BASIN had accumulated undistributed earnings and profits of $2,319,611, and total assets of $2,758,069 and liabilities of $808,132. Among its assets were $138,490 in cash, $1,231,552 in trade notes and accounts receivable (after

allowance for bad debts), and buildings and other fixed depreciable assets with a book value net of accumulated depreciation of $929,306.

OPINION

The issue for decision is whether the cash (boot) received by petitioner had the effect of a dividend under section 356(a)(2), and should therefore be taxed as ordinary income. Resolution of this issue requires us to choose between two judicially articulated tests (the so-called *Wright* test, *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), and the so-called *Shimberg* test, *Shimberg v. United States*, 577 F.2d 283 (5th Cir. (1978)), in interpreting what is, at best, an ambiguous statute. Respondent argues that we should choose the *Shimberg* test and treat the $3,250,000 cash payment as if it constituted a distribution in redemption of stock by the *acquired* corporation (BASIN) prior to, and separate from, the merger. If this is our choice, then, according to respondent, since the redemption fails to satisfy the requirements of either section 302(b)(1) or (b)(2), the cash payment should be treated as a dividend from BASIN under section 356(a)(2) to the extent of its earnings and profits ($2,319,611), and as capital gain in respect of the excess.[2] Petitioner, on the other hand, urges us to choose the *Wright* test and treat the cash payment as a distribution by the *acquiring* corporation (NL) in a hypothetical redemption of the shares of NL stock that would have been received if petitioner had accepted stock in lieu of the cash consideration under the all-stock alternative available to him. Petitioner then argues that such a redemption would have resulted in a meaningful or substantially disproportionate reduction in

[2] Since the amount of the cash is not in excess of petitioner's gain from the exchange, the limitation of sec. 356(a)(1) does not come into play. We note that for the same reason, this limitation does not apply to the *Wright* test advocated by petitioner.

petitioner's stock interest in NL and that consequently, the entire $3,250,000 cash payment should be treated as a payment in exchange for NL stock, under section 302(a),[3] taxable as capital gain under section 356(a)(1). For the reasons hereinafter set forth, in the context of this case, we agree with petitioners.

The issue of choice is not a novel one, although as will subsequently appear, the number of judicial precedents is limited. It has spawned a large number of articles and commentaries of both an historical and analytical nature[4] dealing with the proper test to be used in applying section 356 to acquisitive reorganizations.[5] While we deem it un-

[3] The general rule of sec. 302(a) provides that "If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock."

[4] See Kyser, "The Long and Winding Road: Characterization of Boot Under Section 356(a)(2)," 39 Tax L. Rev. 297 (1984), and citations collected at p. 299, nn. 14 & 15; Rands, "Section 356(a)(2): A Study of Uncertainty in Corporate Taxation," 38 U. Miami L. Rev. 75 (1983); Levin, Adess & McGaffey, "Boot Distributions in Corporate Reorganizations – Determination of Dividend Equivalency," 30 Tax Law. 287 (1977); Golub, " 'Boot' in Reorganizations – The Dividend Equivalency Test of Section 356(a)(2)," 58 Taxes 904 (1980); Comment, "Determining Dividend Equivalence of 'Boot' Received in a Corporate Reorganization," 32 Tax Law. 834 (1979). See also B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, par 14.34, at 14-116 to 14-119 and S14-53 to S14-56 (4th ed. 1979 & Supp. 1985); D. Kahn, Basic Corporate Taxation, par. 10.51 (3d ed. 1981).

[5] Since sec. 368(a)(1)(E) (recapitalization) and (F) (mere change in identity, form, or place of organization) only involves a single corporation, a choice between the *Wright* test and the *Shimberg* test is not required. Similarly, in view of the "solely" requirement of sec. 368(a)(1)(B) (see *Heverly v. Commissioner*, 621 F.2d 1227 (3d Cir. 1980), revg. and remanding *Pierson v. United States*, 472 F. Supp. 957 (D. Del. 1979), and *Reeves v. Commissioner*, 71 T.C. 727 (1979); and

necessary to lay out a detailed, evolutionary history, a brief review of the statutory provisions and their historical genesis appears to be in order as a prerequisite to understanding the parameters of the choice we are called upon to make.

Sections 354 and 356 provide the tax treatment to be afforded shareholders of corporations which are parties to reorganizations qualifiying as such under section 368(a)(1). Specifically, under section 354(a)(1)–

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, *exchanged solely for the stock or securities in such corporation or in another corporation a party to the reorganization.* [Emphasis added.]

In situations in which the reorganization is not a straight stock-for-stock deal, but instead includes some additional consideration, the Internal Revenue Code (the Code) does not simply recategorize the entire transaction as a taxable exchange. Rather, it provides for a limited recognition of gain under section 356(a)(1)–

> (1) RECOGNITION OF GAIN.–If–
>
> (A) section 354 or 355 would apply to an exchange but for the fact that
>
> (B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

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Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980), revg. and remanding *Reeves v. Commissioner, supra*), there never should be any "boot" and hence no occasion for choice where a "B" reorganization is involved. See also *McDonald v. Commissioner,* 52 T.C. 82 (1969), where a choice was made because respondent erroneously conceded the existence of a "B" reorganization (see Rev. Rul 75-360, 1975-2 C.B. 110).

> then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

This gain is to be treated as a capital gain unless the exchange qualifies for dividend treatment under section 356(a)(2), which provides–

> If an exchange is described in paragraph (1) but *has the effect of the distribution of a dividend* * * * then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property. [Emphasis added.]

The precursor of section 356(a)(2) first appeared in the Revenue Act of 1924, which became, without significant change, section 112(c)(2) of the Internal Revenue Code of 1939. The following example, found in the report of the House Ways and Means Committee, is illuminating–

> The necessity for this provision may best be shown by an example: Corporation A has capital stock of $100,000, and earnings and profits accumulated since March 1, 1913, of $50,000. If it distributes the $50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates.
>
> On the other hand, Corporation A may organize Corporation B, to which it transfers all its assets, the consideration for the transfer being the issuance by B of all its stock and $50,000 in cash to the stockholders of Corporation A in exchange for their stock in Corporation A. Under the existing law, the $50,000

> distributed with the stock of Corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12½ per cent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the 12½ per cent rate on capital gain. Here again this provision prevents evasions.
>
> [H. Rept. 179, 68th Cong., 1st Sess. 15 (1924), 1939-1 (Part 2) 241, 252].

Thus, it appears that the primary objective of Congress was to prevent shareholders from bailing out earnings and profits at capital gain rates when in essence the shareholders stood substantially in the same position before the reorganization as they did after the reorganization, i.e., "to prevent the bailout of earnings and profits at capital gains rates through the device of a reincorporation reorganization." See Kyser, *supra* note 4, at 302.

In *Commissioner v. Estate of Bedford,* 325 U.S. 283 (1945), the Supreme Court ruled that any distribution of "boot" pursuant to a reorganization would have the effect of a taxable dividend to the extent of the corporation's accumulated earnings and profits, i.e., the so-called "automatic dividend rule." That decision met with much criticism, however (see, e.g., *Hawkinson v. Commissioner,* 235 F.2d 747, 750-751 (2d Cir. 1956)), and both the courts and the Internal Revenue Service have now retreated from the rule. See, e.g., *Shimberg v. United States,* 577 F.2d at 290; *King Enterprises, Inc. v. United States,* 189 Ct. Cl. 466, 418 F.2d 511, 520 (1969); *Johnson v. Commissioner,* 78 T.C. 564, 575-576 (1982); Rev. Rul. 74-515, 1974-2 C.B. 118, 120.

In its place, the courts have developed a concept which encompasses the determination of whether a distribution has "the effect * * * of a dividend" by looking to the provisions of section 302, although there is no express reference to that section in section 356(a)(2). Most of the courts have said that these two sections are to be read in pari materia. *Wright v. United States,* 482 F.2d at 605; *King Enterprises, Inc. v. United States,* 418 F.2d at 520; *Ross v. United States,* 146 Ct. Cl. 223, 173 F. Supp. 793, 797 (1959); *Hawkinson v. Commissioner, supra* at 751. The Fifth Circuit Court of Appeals, however, has adopted a somewhat more ambiguous approach by embracing and considering section 302 simply as providing " 'in appropriate cases' * * * 'useful guidelines for purposes of applying section 356(a)(2).' " *Shimberg v. United States, supra* at 287 n.13. (Citation omitted.) Although Congress has not chosen specifically to amend the Code to reflect the interrelationship of these two sections, its acquiescence and tacit approval of such a conclusion is apparent in the Conference Committee Report for the Deficit Reduction Act of 1984, in which it was unequivocally stated that "The principles of section 302 are applicable in testing for dividend equivalency under section 356." H. Rept. 98-861 (Conf.) (1984), 1984-3 C.B. (Vol. 2) 1, 99. Furthermore, the Internal Revenue Service has adopted this position in its published rulings.[6] In point of fact, the distinction between the "in pari materia" and the "useful guidelines" standard is little more than one of nuance and without any impact on the instant case since neither standard provides any significant help in making the choice before us.

Turning to section 302(b), we find two situations, insofar as relevant to the case before us, in which a distribution in redemption of stock is to be treated as a distribution in part or full payment in exchange for such stock and

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[6] See Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121; Rev. Rul. 75-83, 1975-1 C.B. 112.

not as a dividend. Section 302(b)(1) provides for such treatment, i.e., capital gain under section 302(a), "if the redemption is not essentially equivalent to a dividend." The Supreme Court has held that for a redemption to meet this test it "must result in a meaningful reduction of the shareholder's proportionate interest in the corporation." *United States v. Davis*, 397 U.S. 301, 312 (1970). Section 302(b)(2)(A) provides for such treatment if the "distribution is *substantially disproportionate* with respect to the shareholder." (Emphasis added.) A distribution qualifies as being "substantially disproportionate" if the shareholder's interest in the voting stock and the common stock (whether voting or nonvoting) of the corporation immediately after the redemption is less than 80 percent of his interest in such stock immediately before the redemption, and if immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote. Sec. 302(b)(2)(B) and (C). If the shareholder falls within this "safe harbor" constructed by Congress, the redemption is deemed to be "substantially disproportionate."

The first case[7] directly to confront the issue of whether, in determining the application of section 356(a)(2), the tests under section 302 should be applied in the context of a redemption by the *acquired* or the *acquiring* corporation was *Wright v. United States, supra*, in which the Eighth Circuit Court of Appeals held that the proper test for determining whether the distribution had "the effect * * * of a dividend" was to view the cash payment as a reduction of the taxpayer's stockholdings in the *acquiring*, i.e., surviving, corporation. In Rev. Rul. 75-83, 1975-1 C.B. 112, however, the respondent expressly rejected the holding in *Wright* and said it would not be followed. Instead, respondent focused on the cash payment as a reduction of the taxpayer's stockholdings in the acquired corporation, prior to the reorganization. The Fifth Circuit Court of Appeals adopted a similar stance in *Shimberg v. United States, supra*, in which it also rejected the holding and reasoning of *Wright* as erroneously placing the emphasis on the surviving, instead of the acquired, corporation. See 577 F.2d at 287.

[7] In *King Enterprises, Inc. v. United States*, 189 Ct. Cl. 466, 418 F.2d 511 (1969), there was no dispute that the dividend determination should be made with reference to the acquired corporation. See 418 F.2d at 521. In *Ross v. United States*, 146 Ct. Cl. 223, 173 F. Supp. 793 (1959), the Court of Claims thought the facts of that particular case so clear that it had no choice but to find that the distribution was made by the acquired corporation. *Hawkinson v. United States*, 235 F.2d 747 (2d Cir. 1956), seemingly determined dividend equivalency in terms of a distribution from the acquired corporation but clearly did not confront the issue of choice between the acquired and the acquiring corporation. See also pp. 151-152, and particularly *infra* note 15, discussing *McDonald v. Commissioner*, 52 T.C. 82 (1969).

Wright v. United States, supra, involved the consolidation of two closely held corporations into a new corporate entity (Omni). The old corporations were commonly owned, but in different proportions. A simple merger involving the exchange of shares of these corporations for shares of Omni would not have resulted in the ownership percentages in Omni desired by the controlling shareholders. As a result, pursuant to the reorganization, "boot," in the form of a promissory note, was paid to the majority stockholder to compensate him for taking a reduced equity interest in Omni.

In determining dividend equivalency, the Eighth Circuit first focused on who in fact issued the note constituting the "boot," i.e., the old corporations or Omni. While recognizing that "it is not material whether the distribution is actually made by the corporation entering the reorganization or by the corporation resulting from the reorganization," the court emphasized that it could not ignore "the factual circumstance that there were two corporations * * * before reorganization and one after reorganiz-

ation." 482 F.2d at 607. The court found that, within the context of the entire plan of reorganization, it was artificial for respondent to contend that the note was issued by the old corporations. Instead the court held that "the note was issued by Omni in exchange for a portion of Omni stock that the taxpayer would have received if he had taken Omni stock entirely instead of receiving Omni stock and a note issued to him by Omni." 482 F.2d at 607. The court concluded that the rationale underlying the redemption provisions mandated such a result—

> The entire concept of a redemption contemplates a change in ownership between an ongoing corporation and a newly formed corporation or within an ongoing corporation itself. For example, underlying the "safe harbor" provision, sec. 302(b)(2), is the rationale that a substantially disproportionate redemption of stock leads to the conclusion that the exchange is a redemption. The percentage requirements, e.g., the 50 per cent rule, refers to the necessity of having 50 per cent of the total voting stock *after redemption*. This rule and other redemption provisions make sense only in relation to a corporation that will continue to exist. If a substantially disproportionate redemption of stock has occurred the distribution clearly can be said to be a sale rather than a dividend because the stockholder has relinquished valuable rights in the future business. Further, the rights of stock ownership—to vote, to participate in earnings, and to share in net assets on liquidation—are all affected by a redemption. But these rights and the effect of a redemption only make sense in relation to a corporation that will be engaged in doing business after the redemption. To analyze the present case as a redemption of [the old corporations'] stock alone * * * is an artificial reading of the redemption provisions, for [the old corporations] were dissolved as part of the Plan. The

> change in ownership that would be significant due to a redemption would be a change in ownership in Omni, the corporation that would exist after the redemption and would have voting stock, earnings, and assets that would be affected. [482 F.2d at 607-608. Emphasis supplied.]

In *Shimberg v. United States, supra*, the Fifth Circuit Court of Appeals was faced with a factual set of circumstances similar to the instant case. The taxpayer in that case owned approximately 67 percent of a LaMonte-Shimberg Corp. (LSC), of which he was president and chief executive officer. Pursuant to a plan of reorganization, LSC was merged into a large publicly held corporation called MGIC Investment Corp. (MGIC) whose stock was traded on the New York Stock Exchange. According to the terms of the merger, the stockholders of LSC received ratably, in exchange for all their LSC stock, stock of MGIC and cash "boot" of $625,000. The taxpayer received $417,449 in cash and stock in MGIC constituting less than 1 percent of MGIC's total shares outstanding. Immediately prior to the merger, LSC had undistributed earnings and profits in excess of $625,000.

As in *Wright*, the issue before the Fifth Circuit was whether the taxpayer's receipt of cash "boot" had the effect of a dividend distribution. The District Court had found for the taxpayer, basing its decision on an apparent misinterpretation of the holding in *Wright*. *Shimberg v. United States*, 415 F. Supp. 832 (M.D. Fla. 1976). After a preliminary discussion of the Eighth Circuit's application of the *Davis* "meaningful reduction" test in *Wright*, the District Court concluded that the taxpayer's relinquishment of ownership and control of a small, local company in exchange for a "miniscule percentage of the outstanding stock of a huge, publicly-held corporation [made it] * * * clear that the merger resulted in a radical change and

meaningful reduction in the nature of the [taxpayer's] interest in the continuing business." 415 F. Supp. at 836. Thus, rather than focusing solely on the taxpayer's interest in the surviving corporation, the District Court misconstrued *Wright* to mean that the proper test for determining dividend equivalency was a comparison between the taxpayer's interest in the acquiring, i.e., surviving, corporation after the reorganization and the interest he held prior to the reorganization in the acquired corporation.

The Fifth Circuit Court of Appeals reversed, finding that the District Court's application of the "meaningful reduction" test of section 302(b)(1) was incorrect and that the "undifferentiating invocation of stock redemption principles in a reorganization case such as this is erroneous." 577 F.2d at 287. It is apparent that the Court of Appeals predicated its rejection of the lower court's holding on its mistaken view that the District Court had properly interpreted and applied the *Wright* test. This is clearly borne out by the court's finding that—

> A contrary holding would render section 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations. And, even in that situation, disproportionate ownership—as in *Wright*—could result in a meaningful reduction. [577 F.2d at 288.[8]]

[8] The Fifth Circuit's misunderstanding of the *Wright* holding is even more clearly evidenced in *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980). In that case, pursuant to a plan of reorganization qualifying as such under sec. 368(a)(1)(C), the two shareholders of Olivier Co., Inc. (Olivier), who held two-thirds and one-third of its stock, respectively, received pro rata cash payments and stock of U.S. Industries (USI), constituting 0.4 percent and 0.2 percent, respectively, of the total outstanding stock of USI. The Fifth Circuit, in discussing the decision in *Wright*, stated—

> "Here, if the *Wright* test were applicable, we would be concerned with a reduction from a 66⅔% and 33⅓% interest in Oliver stock for [the two shareholders] respectively to a 0.4% and 0.2% respective interest in the outstanding USI stock. [615 F.2d at 1066.]"

Once again, the Fifth Circuit misinterpreted the *Wright* test as comparing shareholder interests in the old corporation to those in the surviving corporation.

Having rejected the District Court's analysis, the Fifth Circuit reasoned that, according to the theory and legislative history behind the reorganization provisions "section 356(a)(2) requires a determination of whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred." 577 F.2d at 288. It then concluded that, since absent the reorganization, a pro rata distribution of $625,000 to LSC shareholders would have been a dividend taxable as ordinary income, "The taxpayer should not be able to reap the benefits of capital gain treatment simply because he received his share of the distribution after the merger in the form of a 'boot' rather than before the merger in the form of a dividend." 577 F.2d at 289.

After careful consideration, we have concluded that, at least in the context of the factual situation before us, the *Wright* test is the better choice in respect of the application of section 302 to the determination of whether "boot" has "the effect of the distribution of a dividend" under section 356(a)(2). Several considerations have led us to this conclusion.

The genesis of section 356(a)(2) (see p. 143 *supra*), lay in Congress' concern for the possibilities of manipulated withdrawals within the framework of reorganizations which approached the types of transactions which have been dealt with in later years through the application of

the liquidation-reincorporation doctrine. See B. Bittker & J. Eustice, supra note 4, par. 14.54.[9]

While we recognize this clear intent by Congress to prevent abusive cash bailouts made pursuant to planned reorganizations, as well as the fact that the language used in section 356(a)(2) may have been broader than necessary to deal with the legislative concern, contrary to respondent's position we do not think it follows that we must test "boot" distributions in connection with a reorganization, as if they were made by the acquired corporation prior to and separate from the reorganization. As we have noted in the past, in legitimate reorganizations that substantially reduce a shareholder's ownership interest, although it may be true "that a decision in favor of the petitioner would allow him to withdraw substantial corporate earnings at no tax (or, if his basis in the redeemed stock were less than the amount distributed, at capital gains rates) * * * such result does not require us to hold that the distribution is a dividend." *McDonald v. Commissioner*, 52 T.C. 82, 89 (1969).

Respondent asks us to follow a twisted path. After conceding that the distribution has been made pursuant to a legitimate reorganization under section 368(a)(1)(A), a necessary prerequisite to invoking section 356(a)(2), respondent then asks us to make our determination of dividend equivalency fantasizing that the reorganization does not exist.[10] Clearly, if Congress had wanted the

[9] Subsequent legislative history is of little help in resolving the choice issue. Proposals in 1954 and 1959 seem to have embraced respondent's position herein while more recent proposals embrace the position espoused by petitioner; none of these proposals have been adopted. See Kyser, *supra* note 4, at 322-323; Rands, *supra* note 4, at 93-94; Golub, *supra* note 4, at 905-906; B. Bittker & J. Eustice, *supra* note 4, at S14-51 to S14-56.

[10] See *supra* note 9 for the conflicting attempts by Congress to deal with the choice issue.

distribution to be viewed in this manner, it could easily have said so in 1924 or in connection with the passage of numerous revenue acts in the ensuing 60 years.[11]

We reject respondent's attempt to bootstrap the holdings that the acquired corporation's earnings and profits should be the measure of any dividend under section 356(a)(2) into a conclusion that the determination of the requisite reduction in interest under section 302(b) must be necessarily made with reference to the same corporation. In our opinion, there is no such necessary correlation. There is no reason why the redemption cannot be considered as having been made by one corporation with the consequences to be measured by the earnings and profits of another corporation. Compare section 304(b)(1) with section 304(b)(2)(A). Moreover, the courts are not in agreement as to the standard of measurement to be used. See *Atlas Tool Co. v. Commissioner*, 70 T.C. 86, 106-107 (1978), affd. 614 F.2d 860, 868 (3d Cir. 1980).[12] Indeed, respondent on brief has made it clear that his acceptance of the agreed stipulation of the parties that the earnings and profits of BASIN will be the measure of any dividend determined herein is not to be construed as an acceptance of this test in any other case.

Respondent's attempt to view the cash payment as an isolated event totally separate from the reorganization runs counter to the established case-law principle known as the "step-transaction" doctrine—a doctrine which respondent has zealously and generally successfully sought to apply in the reorganization arena. See Levin, Adess & McGaffey, *supra* note 4, at 290; Rands, *supra* note 4, at 117. In *McDonald v. Commissioner, supra*, we held that

[11] Furthermore, the limitation of dividend treatment contained in sec. 356(a)(2) is a clear indication that Congress considered the boot distribution to be an integral element of the reorganization. See Levin, Adess & McGaffey, *supra* note 4, at 303.

[12] See also *Davant v. Commissioner*, 366 F.2d 874, 887-890 (5th Cir. 1966), revg. on this issue *South Texas Rice Warehouse Co. v. Commissioner*, 43 T.C. 540, 570-572 (1965); *American Manufacturing Co. v. Commissioner*, 55 T.C. 204, 230-231 (1970).

the "step-transaction" doctrine, first set forth in *Zenz v. Quinlivan* 213 F.2d 914 (6th Cir. 1954),[13] was "applicable in determining whether a redemption is essentially equivalent to a dividend within the meaning of section 302(b)(1)," 52 T.C. at 87. The facts in *McDonald*, simply stated, are as follows. Taxpayer owned 10 of the 11 shares of the common stock of E & M Enterprises, Inc. (E&M), and all of its preferred stock. Pursuant to a plan of reorganization, E&M redeemed all of taxpayer's preferred stock for $43,500, and Borden Co. (Borden), the corporation acquiring E&M, gave 4,839 of its shares in exchange for the 11 shares of E&M common stock. E&M acquired the cash to carry out the redemption by obtaining a short-term bank loan. A week after the redemption, E&M and Borden exchanged their shares and Borden transferred cash to E&M which was used in part to pay off the loan. Respondent argued that the redemption by E&M of taxpayer's preferred stock was a totally separate transaction and thus taxable as a dividend.[14] In holding for the taxpayer, we recognized that "The record in this case establishes clearly that the *redemption was merely a step in the plan of Borden for the acquisition of E&M, so that it is the results of the plan that are significant to us.*" 52 T.C. at 87 (emphasis added). We concluded that "Taking into account all the circumstances of this case * * * the redemption and the reorganization effected such a substantial change in the petitioner's interest in E&M as to establish that the redemption was not essentially equivalent to a dividend." 52 T.C. at 89.

[13] The taxpayer in *Zenz* wished to sell all the stock in a corporation in which she was the sole stockholder. To satisfy the wishes of the purchaser who did not want to buy all the stock of the corporation, the parties agreed upon a plan under which the purchaser bought part of the stock and the corporation redeemed the remaining shares. The court viewed the steps in the transaction as part a single integrated plan intended to totally liquidate the taxpayer's holdings in the corporation. In light of this, the court held that redemption was not essentially equivalent to a dividend because it completely terminated her interest in the corporation. See 213 F.2d at 917.

[14] It should be noted that, at trial, respondent considered the redemption and exchange to be separate transactions and therefore conceded that the exchange constituted a tax-free reorganization under sec. 368(a)(1)(B). 52 T.C. at 86. However, in Rev. Rul. 75-360, 1975-2 C.B. 110, the respondent recognized that –

> "it was in error in arguing the various steps were separate transactions thereby affording tax-free treatment on the stock exchange. Accordingly, since the acquisition was not solely for voting stock of the acquiring corporation, but partly for cash, that the acquisition of stock of E&M did not constitute a reorganization. Therefore * * * the entire transaction is considered a taxable sale or exchange."

We recognize that some argument can be made that the same failure to apply the step-transaction doctrine exists in applying the *Wright* test in that such test involves viewing the cash payment as being in redemption of an imputed number of shares of the acquired corporation after the reorganization has occurred. See Rands, *supra* note 4, at 102-103. But we think this argument fails in that the *Wright* test treats the cash payment as the equivalent of a redemption *in the course of implementing the reorganization*, while the *Shimberg* test, advocated by respondent, requires that the redemption by the acquired corporation be treated as having occurred *prior to and separate from the reorganization*. Clearly, the cash payment in situations of the type involved herein would not have taken place without the reorganization. The same cannot be said of the redemption created by the *Shimberg* test.

In view of the foregoing, we conclude that the determination of whether the cash payment to petitioner had "the effect * * * of a dividend" should be viewed and tested within the context of the entire reorganization. To hold otherwise, and view and test the cash (boot) as if it were distributed as a hypothetical redemption by BASIN prior to the reorganization, would in effect resurrect the

now discredited "automatic dividend rule" (see pp. 143-144 *supra*), at least with respect to pro rata distributions made to an acquired corporation's shareholders pursuant to a plan of reorganization.

We turn now to the question whether petitioner, as a result of the reorganization, suffered a reduction in interest sufficient to qualify the cash he received as a redemption under section 302(b). In resolving this question, we apply the test enunciated in *Wright v. United States, supra*, and look at the effect of the reorganization on petitioner's potential and actual interest in NL, the acquiring, i.e., surviving, corporation.[15]

Pursuant to the plan, petitioner received 300,000 shares of NL common stock, which constituted approximately 0.92 percent of the total shares outstanding of NL common stock after the merger. If petitioner had accepted the all stock offer, he would be received 425,000 shares of stock, which would have constituted approximately 1.3 percent of NL's total shares outstanding. By treating the cash "boot" as a redemption of petitioner's shares, we find that the cash distribution reduced petitioner's interest in NL by approximately 29 percent (from 1.3 percent to 0.92 percent) so that his post-distribution holdings were only approximately 71 percent of what they would have been absent the distribution. Coupled with the fact that petitioners held less than 50 percent of the voting stock of NL after the redemption, under section 302(b)(2) the distribution qualifies as being "substantially disproportionate" and is not taxable as a dividend. Since the distribution falls within the mechanistic "safe harbor" of section 302(b)(2), we need not decide if the redemption resulted in a meaningful reduction of petitioner's stock interest under section 302(b)(1).

[15] We recognize that it is possible to construe our opinion in *McDonald v. Commissioner*, 52 T.C. 82 (1969), as adopting a test based upon a comparison of a taxpayer's stock interest in the acquiring corporation with his prior interest in the acquired corporation. However, we think it significant that *McDonald* was decided prior to either *Wright* or *Shimberg*, that the issue before this Court was simply whether the redemption was separate from, or an integral part of, the reorganization, and that it appears that the acquired versus acquiring corporation test for applying sec. 356(a)(2) was not presented to us. Such being the case, and particularly since the result in *McDonald* would have been the same under the *Wright* test, we do not view our opinion in *McDonald* as inhibiting our freedom to choose the test which should be applied herein.

In point of fact, respondent does not argue that the required reduction in petitioner's interest does not exist if the *Wright* test is applied. Rather, the heart of respondent's position is that use of the *Wright* test results in an "automatic capital gain" rule. Respondent argues that, in cases involving factual circumstances similar to the instant case, in which the "whale" swallows the "minnow" and gives the shareholders of the acquired corporation a pro rata distribution of boot in addition to stock, those shareholders will always be afforded capital gain treatment. He reasons that if a shareholder in a small closely held corporation exchanges his interest in that corporation for what must be, almost by definition, a much smaller percent of ownership in a large publicly held corporation, a comparison of these percentage ownership figures will always be so disparate as to qualify as a meaningful reduction or as substantially disproportionate in the context of a redemption by the acquiring corporation. In effect, respondent's position is rooted, as was that of the District Court in *Shimberg v. United States*, 415 F. Supp. 832 (M.D. Fla. 1976), in an erroneous equating of the *Wright* test with a comparison of a taxpayer's interest in the acquired corporation before the reorganization with his interest in the acquiring corporation after the reorganization. See pp. 147-150 *supra*. We think we have made it clear that the *Wright* test does no such thing. It simply compares the stock interest which a taxpayer actually receives in the acquiring, i.e., surviving, corporation in a

reorganization with what he would have received if he had obtained additional stock in lieu of the cash payment. Whether the results of such a comparison indicate dividend or capital gain treatment will vary, depending on the facts and circumstances of each individual case. We think it significant that respondent in substance accepts the facts and circumstances limitation in situations involving section 356(a)(2).[16] In so doing, he reflects the same uncertainties as those of the Fifth Circuit in *Shimberg v. United States, supra*—uncertainties which, in a sense, are also present in our reservation of the same limitation in adopting the *Wright* test.[17]

[16] We quote from respondent's brief (p. 27):

"We are only addressing in this brief a factual situation which is identical to the one present in *Shimberg* where a small corporation (the "minnow") was merged into a large corporation (the "whale"), there had been no previous commonality of ownership between the two corporations, the "minnow's" shareholders received cash and stock on a pro rata basis, the "minnow's" shareholders stock ownership in the "whale" was very small vis-a-vis the number of shares outstanding, and the acquired corporation had a significant amount of accumulated undistributed earnings and profits."

In connection with the facts and circumstances limitation, we observe that respondent objected at trial to the relevancy of any testimony regarding the merger negotiations. We overruled respondent's objection and reserved to respondent the right to argue the question of admissibility on brief. We are satisfied that we should adhere to our ruling at trial. See *McDonald v. Commissioner*, 52 T.C. 82, 88 (1969).

[17] It is interesting to note that the Court of Appeals in *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973), would have reached a different conclusion if the attribution rules of sec. 318(a) had been applied. See 482 F.2d at 610. See also Kyser, *supra* note 4, at 312 n. 78. Under sec. 227(b) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub. L. 97-248, 96 Stat. 324, 492, the attribution rules of sec. 318 now apply to "boot" payments falling within sec. 356(a).

While we are satisfied that the *Wright* test should not be equated with the comparison erroneously made by the District Court in *Shimberg v. United States, supra*, we think that the minnow-whale scenario is a background element which can be taken into account. Cf. *McDonald v. Commissioner, supra*. See also *supra* note 15.

If we look at the particular facts and circumstances of the instant case, the correctness of our conclusion that the cash distribution of $3,250,000 did not have "the effect * * * of a dividend" under section 356(a)(2) becomes even clearer. There is not the slightest evidence that the cash payment was a concealed distribution from BASIN.[18] Indeed, it is hard to conceive that such a possibility could even have been considered, for a distribution of that amount was not only far in excess of the accummulated earnings and profits ($2,319,611), but also of the total assets of BASIN ($2,758,069). In fact, only if one takes into account unrealized appreciation in the value of BASIN's assets, including good will and/or going-concern value, can one possibly arrive at a $3,250,000. Such a distribution could only be considered as the equivlalent of a complete liquidation of BASIN, which would call for capital gain treatment under *Zenz v. Quinlivan, supra*. Moreover, the record herein makes it clear that it was NL which developed the stock plus cash alternative and that its foundation was attributable to a desire of NL to minimize the number of shares outstanding. In this connection, we think that the question of whether the shareholders of the acquired corporation are given a choice

[18] It is in this context that the facts and circumstances analysis might well produce a different result when there is persuasive evidence of an identity between the amount of the cash payment, the earnings and profits of the acquired corporation, and available liquid assets to support the conclusion that the acquiring corporation was a conduit for the payment. Cf. *Ross v. United States, supra* note 7. The problem of identification of the source of a cash payment is not without its difficulties. See Levin, Adess & McGaffey, *supra*, note 4, at 290 n. 15.

between all stock and stock plus cash in the acquired corporation is not the significant factor. See *McDonald v. Commissioner, supra* at 89. As a general rule, we would apply the *Wright* test where only the latter offer was available. However, the source of the offer in whatever form may be a fact and circumstance to be taken into account in certain situations. See *supra* note 18.

Our analysis of the issue before us herein has convinced us that neither the *Shimberg* test nor the *Wright* test can be inexorably applied to "boot" distributions in connection with a reorganization, fully within which the ambit of section 356(a)(2). Each test has its supporting and criticizing arguments. See, e.g., Kyser, *supra* note 4; Rands, *supra* note 4; Levin, Adess & McGaffey, *supra* note 4; Comment, *supra* note 4. However, we think that, on balance, the *Wright* test is the more suitable vehicle for decision principally because its application produces a result more within the scope of the type of reorganization Congress had in mind in enacting section 356(a)(2), i.e., where there is an overlapping of ownership between the acquired and acquiring corporations, than the *Shimberg* test which would tend to produce exactly the opposite result. Moreover, unlike the *Wright* test, the *Shimberg* test would make the result dependent upon which corporation, the acquired or the acquiring, survived a merger. Indeed the deficiencies in the *Shimberg* test are sufficient to cause its supporters to suggest that the *Wright* test be applied where there is a "commonality" of ownership of the acquired and acquiring corporations and the *Shimberg* test be reserved for situations where such commonality does not exist. See, e.g., Kyser, *supra* note 4, at 331; Rands, *supra* note 4, at 116. We have difficulty in applying such a bifurcated approach to a statute which seems to make no distinction between different reorganizations. Cf. *American Manufacturing Co. v. Commissioner*, 55 T.C. 204, 230-231 (1970); Levin, Adess & McGaffey, *supra* note 4,

at 306. Furthermore, such an approach would add another difficult dimension to the application of section 356, i.e., determining how much overlap of stock ownership would constitute commonality. See Kyser, *supra* note 4, at 329-332.

One final word. The root of the problem of choice between the *Wright* test and the *Shimberg* test lies in the low level of "continuity of interest" required to constitute a type of tax-free reorganization. The result of this low-level requirement is to cause transactions to be treated as reorganizations which really should be considered sales, i.e., where there is a substantial amount of cash paid and/or the stock of the acquiring corporation can be readily disposed of by the taxpayer. See, e.g., Kyser *supra* note 4, at 315 n. 90 and 340. But this condition has existed far too long for the judiciary now to change the rules of the game. If a change is to come, it must come from the legislature. We think the same is true with respect to adopting a bright-line test, under section 356(a)(2), i.e., a rule applicable without qualification to all cases, to determine whether a distribution has "the effect * * * of a dividend." In the meantime, the courts, the Executive, and taxpayers will be forced to live with a test which admittedly is imprecise in that it will not be inexorably applicable in all situations.

To reflect the foregoing and petitioners' concessions on other issues,

Decision will be entered under Rule 155.

Reviewed by the Court.

STERRETT, GOFFE, NIMS, PARKER, WHITAKER, KÖRNER, SHIELDS, HAMBLEN, COHEN, CLAPP, SWIFT, JACOBS, WRIGHT, and WILLIAMS, *JJ.*, agree with this opinion.

SIMPSON, WILBUR, CHABOT, GERBER, and PARR, *JJ.*, did not participate in the consideration of this case.

APPENDIX C

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 86-1736

DONALD E. CLARK; PEGGY S. CLARK,
PLAINTIFFS-APPELLEES

v.

COMMISSIONER OF INTERNAL REVENUE,
DEFENDANT-APPELLANT

Appeal from the Tax Court of the United States

[Filed: September 4, 1987]

JUDGMENT

This cause came on to be heard on the trancript of the record from The Tax Court of the United States, and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the decision of said The Tax Court of the United States, in this cause, be, and the same is hereby, affirmed.

/s/ JOHN M. GREACEN
John M. Greacen
Clerk

A True Copy, Teste:
John M. Greacen, Clerk
By: BARBARA RAVE
Deputy Clerk

APPENDIX D

The Internal Revenue Code (26 U.S.C.) provides in pertinent part:

Section 302. *Distributions in redemption of stock*

(a) *General rule*

If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part of full payment in exchange for the stock.

(b) *Redemptions treated as exchanges*

(1) *Redemptions not equivalent to dividends*

Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) *Substantially disproportionate redemption of stock*

(A) *In general*

Subsection (a) shall apply if the distribution is substantially disproportionate with respect to the shareholder.

(B) *Limitation*

This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) *Definitions*

For the purposes of this paragraph, the distribution is substantially disproportionate if –

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time,

is less than 80 percent of –

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) *Series of redemptions*

This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disappropriate with respect to the shareholder.

(3) *Termination of shareholder's interest*

Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) *Redemption from noncorporate shareholder in partial liquidation*

Subsection (a) shall apply to a distribution if such distribution is—

(A) in redemption of stock held by a shareholder who is not a corporation, and

(B) in partial liquidation of the distributing corporation.

(5) *Application of paragraphs*

In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

Section 316. *Dividend defined*

(a) *General rule*

For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

Section 317. *Other definitions*

(a) *Property*

For purposes of this part, the term "property" means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock).

(b) *Redemption of stock*

For purposes of this part, stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired, or held as treasury stock.

Section 354. *Exchanges of stock and securities in certain reorganizations.*

(a) *General rule*

(1) *In general*

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(3) *Cross reference*

(A) For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered, but not including property to which paragraph (2)(B) applies), see section 356.

Section 356. *Receipt of additional consideration*

(a) *gain on exchanges*

(1) *Recognition of Gain*

If–

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend*

If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

* * * * *

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